

**Information for the House Committee on Ways & Means
Tax Reform Working Group on Charitable/Exempt Organizations**

Submitted by:

Council on Foundations

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April 15, 2013

On behalf of Council on Foundations (“Council”), I would like to commend the House Ways and Means Committee, under the leadership of Chairman Dave Camp and Ranking Member Sander Levin, for embarking on the daunting task of comprehensive tax reform and establishing a formal process for stakeholder interaction. The Council submits the following comments to the Working Group on Charitable/Exempt Organizations for its consideration. We would also like to thank the Charitable/Exempt Organization Working Group Chairman Dave Reichert and Co-chairman John Lewis for their sincere interest in the charitable and philanthropic sectors and their willingness to address a range of important issues.

The mission of the Council on Foundations is to provide the opportunity, leadership, and tools needed by philanthropic organizations to expand, enhance, and sustain their ability to advance the common good. Our nonprofit association, which has served our members for more than 60 years, represents over 1,700 grantmaking foundations and corporations.

The Council is both interested and engaged in several issues related to the tax code and its impact on philanthropic organizations. In these comments, we would like to address two issues that were specifically raised in the February 14, 2013, Ways and Means Committee hearing on Tax Reform and Charitable Contributions: (1) the charitable deduction; and, (2) the private foundation excise tax.

The Charitable Deduction:

The Council on Foundations is on record, individually and as a member of the Charitable Giving Coalition (www.preservegiving.org), imploring both Congress and the Administration to preserve the current itemized deduction. Our message, and that echoed by scores of our colleagues in the field, is that the deduction is crucial for the wellbeing of America’s charities and the diverse constituents they serve. Today, Council President and CEO Vikki Spruill made the following statement on the charitable deduction in response to the Administration’s proposal to cap the deduction as part of its FY2014 budget:

“[Proposals to cap the charitable deduction amount] to a dangerous experiment with America’s nonprofit sector, providing support for some causes while undercutting

crucial private contributions, a core source of support necessary to their survival. There is a reason this unique, century-old tax incentive persists today—it works.

“Any change would compromise the capacity of nonprofits to serve and would diminish their impact on society. It could cause a decline in contributions of at least \$5.6 billion each year, according to recent economic studies. Policymakers characterize the charitable deduction as a tax benefit for the wealthy, but the stark, undeniable reality is that the deduction benefits our fellow citizens in greatest need of a helping hand and the broad, diverse causes that sustain our social sector.

“The Council is committed to supporting our members as they work to alleviate many of the social challenges brought about by today’s economic realities, serve their communities, enrich the lives of their neighbors, and help the most vulnerable. To be successful, we must safeguard the future of philanthropy and the communities that depend on it.”

The Charitable Giving Coalition has also submitted comments to this working group. The Council fully supports those comments and the efforts of our coalition colleagues to work together on this important issue.

At the February 14, 2013 hearing, the Council was pleased that Kevin Murphy, president of Berks County (PA) Community Foundation and chairman of the board of the Council on Foundations, testified before the Committee. Mr. Murphy movingly illustrated to the committee the true beneficiaries of the charitable deduction, drawing upon both his professional and personal experiences. Mr. Murphy and the Council continue to receive strong, positive responses to this testimony. We therefore incorporate it into these comments by attachment (Attachment 1).

The Council will continue its efforts as a vocal proponent of the charitable deduction. We invite both committee members and staff to contact us for additional information.

Private Foundation Excise Tax:

During the question & answer segment of the February 14th hearing, Congressman Earl Blumenauer raised the private foundation excise tax. Witness Eugene Steuerle of Urban Institute responded stating that in his opinion, the excise tax “is silly... and I would eliminate it.”

In the Council’s written statement to the Committee hearing record, we echoed Mr. Steuerle’s critical assessment of the current scheme, citing both the complexity of the two-tier structure and the disincentive that structure presents when foundations seek to increase giving, for example to meet unanticipated needs such as disasters. We also agreed with Mr. Steuerle’s recommendation to eliminate the tax or, in the least, simplify the complicated structure.

As the working group is well aware, the excise tax on the investment income of private foundations originated in the Tax Reform Act of 1969 (P.L. 91-172). The General

Explanation of the Tax Reform Act of 1969 (JCS-16-70) states that the reason for enacting the excise tax was because “Congress concluded that private foundations should share some of the burden of paying the cost of government, especially for the more extensive and rigorous enforcement of the tax laws relating to exempt organizations.” At the same time, it did not want to subject private foundations to income tax. Therefore, it created an excise tax “with respect to the carrying on of the organization’s activities;” over the years, the two-tier structure was implemented. The amounts collected by the Treasury under this provision are not deposited in a separate account for tax-exempt organization enforcement activities, however; they go into the general Treasury fund.

A 2006 study by Professors Richard Sansing of Dartmouth and Robert Yetman of the University of California found that current law can have “countervailing effects on foundation behavior.” It also noted that current law “creates a tax-induced incentive” to reduce contributions in “difficult economic times” such as we are now experiencing “because a high distribution this year makes it more difficult to qualify for the lower rate during the next 5 years.” That is particularly true if, as in the recent past, asset values have declined sharply, thus reducing the denominator by which payout rates are calculated. In such instances, foundations subject themselves to higher tax rates in future years unless they also reduce the dollar amount of their giving at a time when such support is most needed.

On March 20, 2013, the Charitable/Exempt Organizations working group sought input from some foundation leaders on the real-world impact of the private foundation excise tax. Eugene Cochrane, President of The Duke Endowment, recounted for the working group his recent experience. Working group staff asked Mr. Cochrane if he would summarize his account in writing for the working group record. Attached, please find Mr. Cochrane’s summary (Attachment 2).

The Council, along with our individual, private foundation members, is certainly available to the working group and the committee to provide further information.

Thank you.

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ATTACHMENT 1:

Testimony of Kevin K. Murphy
President, Berks County Community Foundation
Chairman of the Board, Council on Foundations

Before the:
U.S. House of Representatives
Committee on Ways and Means

Hearing on:
Tax Reform and Charitable Contributions

February 14, 2013

Good morning, Chairman Camp, Ranking Member Levin, and members of the committee. Thank you for your leadership in assembling this hearing, and I want to thank my friend Congressman Gerlach for helping to make my appearance possible. The congressman is a strong partner in our work in the community.

My name is Kevin Murphy and I serve as president of Berks County Community Foundation, headquartered in Reading, Pennsylvania. Berks County Community Foundation was founded in 1994 to promote philanthropy and improve the quality of life for the over 400,000 residents of our county. My foundation is just one of over 730 community foundations serving urban and rural areas across the country. In addition, I am currently chairman of the board of the Council on Foundations, of which Berks County Community Foundation is a member. The Council on Foundations is a membership organization representing about 1,700 of our nation's grantmaking foundations.

I appreciate this opportunity to testify on the impact of Section 170 on philanthropic organizations and, most importantly, upon those we serve. My experience as president of a medium-sized community foundation gives me a firsthand view on how the charitable deduction—and proposed changes to it—may affect our neighbors who are most in need.

According to the 2010 census, our county's principal city, Reading, has the highest share of residents living in poverty in the nation. Yet the resources that our community has to meet our many pressing needs are very limited, both in the public and private sector. Berks County Community Foundation and other philanthropies provide essential help, both by providing material assistance and by developing innovative ways of maximizing the impact of our resources.

Our donors, too, must deal with very real financial considerations. Our community does not have aggregations of great wealth. Our donors are part of the business, civic, and philanthropic fabric of the Berks County community, who seek to make a real difference in the lives of their neighbors. The donors upon whom we rely are extremely sensitive to changes in the tax code, which can significantly limit what they are able to contribute.

We are proud of our community's tradition of pulling together to help each other. The people who live in our county are an economically diverse lot and have a long history of helping their neighbors in need through charitable giving. Of course, we're not alone. Charitable giving is a uniquely American tradition and is, in fact, one of the defining characteristics that makes this country exceptional.

I don't know of anything that more clearly illustrates that tradition than this backpack. Every Friday afternoon, the Greater Berks Food Bank delivers over 400 of these backpacks to schools in Berks County. The backpacks go home with elementary school students who otherwise wouldn't have food to eat for the weekend. We even had to get backpacks with wheels because some of the children were too small to carry a backpack this big. Before this program, many of those students would show up to school on Monday morning sick from hunger.

We should all take a second to imagine what it is like to be a six-year-old child and to know that this backpack is your only way to avoid hunger.

What's important for the members of the committee to understand about these backpacks is that there are no federal, state, or local governmental dollars invested in this program. This effort—these backpacks—are funded entirely by foundations, corporations, and individuals in our community through charitable contributions. And yes, some of those people probably deduct that contribution from their income tax.

Ladies and gentlemen, I submit to you that the charitable deduction and its encouragement of charitable giving is hardly a loophole or a benefit for the rich. To the contrary, it is a means to help ensure that we care for the poor. Because of philanthropy, the Bill and Melinda Gates Foundation projects that there will be no cases of polio in the world by the close of this current decade—and there hasn't been a case in the United States since 1979. The people who don't get polio are the ones who benefit from the charitable deduction.

The conversation within the Beltway about the charitable deduction has become remarkably unglued from the reality of the community I work in.

In communities across the country, donors are struggling to keep our libraries open so that people without Internet access can seek jobs and learn about health care. For example, McDonalds only accepts job applications online. We tested it, and sent a foundation staffer to apply in person. She was referred by the McDonalds to the public library where she could apply online. Philanthropic investment helps public libraries stay open, allowing people a chance at a job. The true beneficiary of the charitable deduction is the job seeker, and the community that still has this lifeline of information and access available to them.

We're fortunate in Reading that Terry McGlinn and his family were able to donate the money to build a cancer center at our local hospital. Mr. Chairman, I have 17-year-old twin boys. Like any 17-year-old boys, there are days where you wonder if they remembered to turn on their brains in the morning. But in their worst moments, Carver and McQuillin know that they are the ones who benefitted from the McGlinn's gift because their mother is still alive seven years after being diagnosed with cancer and being treated at the McGlinn Regional Cancer Center.

We need to remember that the charitable deduction is unique in two key respects.

First, the charitable deduction encourages behavior that benefits society, NOT the taxpayer. No matter how big the deduction is, it is a simple statement of economic truth that any charitable contribution an individual makes leaves them with less money than they had before they made the gift. Charitable giving, even with a federal incentive, does not leave our donors in a better financial position.

Second, charitable giving is discretionary. Taxpayers have to pay their mortgage. Taxpayers have to pay their state and local taxes. Taxpayers don't have to make charitable contributions. Thus, logic suggests that charitable contributions would be most sensitive to any changes to the deductions permitted under current law.

Further, the charitable deduction should not be viewed as a cost to the government. Philanthropy eases the burdens of government, and reduces taxpayers' costs, by meeting needs that otherwise would have to be met by government, and by pioneering more cost-effective and efficient ways to meet those needs. Charitable giving in this country often forms our final safety net, and we cannot afford to put at risk the people who rely on it.

Efforts to cap, limit, or even eliminate the charitable deduction would be a dangerous social experiment. I have heard economists argue both sides of the issue—which is what economists do. The whole discussion among tax economists brings to mind President Reagan's observation that "An economist is someone who sees something that works in practice and wonders if it works in theory."

In all my years of working with donors, I've never seen a donor make a gift because there's a charitable deduction. I have seen, on thousands of occasions, donors who have come to understand that the deduction allows them to make a bigger gift, to reach a little farther with their philanthropy, to dream a little bigger.

I'm not an economist, but the simple math shows that President Obama's proposal would result in the tax value of charitable deductions being reduced by 29.2 percent (the difference between 39.6 percent and 28 percent). I can't run numbers and quantify with precision what effect altering the charitable deduction would have on charitable giving, and I honestly doubt that others can either. What I can tell you is that the charitable deduction works in practice for this country. We should not undertake an experiment that is premised on the notion that maybe the current deduction is not so important after all. My experience in Berks County has taught me otherwise. My greatest fear is that, as a result of reckless policy, on some Friday we wouldn't have these backpacks to hand out. That would be an awful way to learn a lesson.

Our system of incentives for charitable giving is one of the great American success stories. It benefits millions of Americans who need help every day. We owe it to those Americans not to diminish those incentives.

(END)

ATTACHMENT 2:

The Duke Endowment – Excise Tax

Private foundations must distribute their “minimum investment return” each year, which is statutorily defined as 5 percent of non-charitable use assets, after certain adjustments (commonly referred to as the 5% payout). The Tax Reform Act of 1969 established an excise tax on a private foundation’s “net investment income,” which consists of income received from non-charitable use assets. The tax rate on this income is currently 2%, but can generally be reduced to 1% if the foundation makes qualifying distributions in excess of its average distribution over the prior 5 years.

The relationship between the 5% payout and the excise tax rate can be actively or passively managed by private foundations. Many foundations similar to The Duke Endowment (the “Endowment”) use what could be called an opportunistic approach. The Endowment manages the spending rate applied to its non-charitable use assets so that the rate aligns with expected investment returns and stays within a reasonable range of the required 5 percent payout. Throughout the year, the Endowment studies the amount of its investment income and its annual payout to see if there is an opportunity to reduce the excise tax rate from 2 percent to 1 percent. Critical considerations include: 1) realized investment gains and losses, 2) market appreciation and depreciation of non-charitable use assets, 3) scheduled grant payments, 4) the average distribution over the previous 5 years, 5) the number of operating grants vs. programmatic grants, and 6) a grantee’s fiscal year (e.g., if a grantee has a June 30 fiscal year, a payment can be made in December or January of that fiscal year, depending on the Endowment’s needs).

Taking into account its spending rate and various key elements, the Endowment can fairly accurately manage distributions to optimize its excise tax rate. Large private foundations can more easily manage the excise tax rate because most have experienced staff. Many smaller private foundations passively manage the excise tax because of inadequate staffing and the inability to navigate the excise tax rules. In many cases, the tax firm that prepares the 990PF for smaller foundations manages the 5% payout.

The Endowment has been able to qualify for the 1% rate in 11 of the last 16 years (1996-2011). The implications of the 1 to 2 percent rate can be measured by a net savings of almost \$25 million being passed along in qualified distributions (e.g., grant payments) that would have otherwise been paid in taxes. During this time frame, the Endowment’s prior 5-year average increased from 4.17% to 5.33%.

Most financial modeling suggests that if an endowment’s spending rate is much more than 5%, its principal/corpus will erode over time, jeopardizing its long-term existence. Every so often, perpetual foundations must hit a “reset button” on their 5-year average to gain control over 1) their spending rate (or risk spending itself out of existence) and 2) their ability to qualify for the reduced tax rate in the future. The trouble is that this reset could occur in a year when the market takes a dramatic downturn, as in 2008. The natural tendency for a private foundation during a down market is to pull back on giving because its spending rate might skyrocket (making it more difficult to qualify for the 1% rate in the future). The problem is that the

foundation reduces spending at a time when its grantees may need it the most. Another consequence with resetting the 5-year average is that grant payments might swing dramatically from one year to the next. This volatility in spending creates uncertainty for grantees and can jeopardize the services they provide to the public.

Taking the opportunistic approach described above, the Endowment strategically adjusted its giving with minimal impact on its grantees and paid 2% each of the past 4 years. The excess tax paid over the 4 years was approximately \$3 million. As a consequence, the 5-year average is projected to fall from 5.33% to approximately 5.11%.

(END)

